UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Electrification Administration
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To: REA Staff

From: George W. Haggard, Deputy Administrator

Subject: Capital Credits Information

Every REA staff member who may have occasion to discuss the desirability of the Capital Credits plan with co-op officials will find it helpful to read, and keep for handy reference, the attached statement made by Attorney Hensel at the Region IV NRECA meeting. Mr. Hensel is one of the outstanding legal counselors in the American farm co-op movement. What he has to say is of particular interest in view of the fact that he is not directly connected with the REA program. His statement is a very useful addition to the explanatory literature on the subject.

Attachment

George W Haggard

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CAPITAL CREDITS AND RURAL ELECTRIC COOPERATIVES

(Address by E. L. Hensel, Attorney-at-law, 8 East Long Street, Columbus, Ohio, before Region IV Meeting of National Rural Electric Cooperative Association, at Detroit, Michigan, September 27, 1949)

It has been suggested that this discussion be limited to so-called "capital credits", as the same may be applicable to the organization and operation of rural electric cooperatives. At the outset, let it be understood that the discussion is bottomed on the premise that rural electric cooperatives are generally considered as essentially nonprofit corporations. As to nonprofit corporations, the rule has been well established that substance, and not mere form, controls in determining whether a corporation is actually one not for profit.

In a leading case, it has been stated, with respect to alleged nonprofit corporations, as follows:

> "Nor would a mere declaration in its certificate of incorporation that it was organized not for profit be sufficient to stamp upon it a nonprofit character. In each case, when the corporation is examined, the true facts must be ascertained and the corporation judged accordingly, no matter what its scheme of operation, or its pretentions may be." (1)

In applying the test as to the true nonprofit character of a rural electric cooperative, the use of the capital credit plan plays a most important, if not a controlling part. The articles of most such cooperatives contain a statement to the effect that:

> "The corporation shall operate on a cooperative basis and not for profit.",

or words of similar import. But it is submitted, in the light of the decided cases, that the mere use of words alone is not sufficient to convert into a corporation not for profit such a cooperative which operates, in fact, on a profit making basis, or on a basis which is susceptible of earning corporate profits, even though, in fact, no profits are actually realized.

The nonprofit character of a rural electric cooperative may become of utmost importance in determining (a) its qualification to borrow money through the Rural Electrification Administration;

(b) The exercise of rights asserted in its charter under the State law of incorporation;

(c) In some instances, its amenability to the jurisdiction of the public service commission;

(d) Its eligibility to income tax exemption under Section 101(10), Internal Revenue Code; and

(e) If ineligible to outright income tax exemption, its right to exclude the excess of receipts over expenditures from gross taxable income.

In the event of the repeal of Section 101(10), I.R.C., by the Congress, which does not appear to be a probability, but is, none the less, a possibility, at this time, the tax position of the cooperative may be vitally affected by its use or non-use of the capital credit plan.

Before examining into the nature, functions, characteristics and process of the creation of so-called capital credits, some brief reference should be properly made to statutes and regulations of general application, as distinguished from state statutes or regulations of purely local application.

Insofar as governmental loans to rural electric cooperatives are concerned, the Administrator of the Rural Electrification Administration is authorized to make loans only to "cooperative, non-profit or limited dividend associations." (2) The sentence structure would lend strong support to the view that the hyphenated word "non-profit" is descriptive of the type of association denominated in the statute as "cooperative", which view is strengthened by the decisions of Federal Courts, to which reference will be hereafter made.

Insofar as outright exemption from federal income taxes is concerned, the right to such exemption, if any, (and this is said advisedly) arise out of the provisions of Section 101(10), I.R.C. (3) , which is quoted as follows:

> "Benevolent life insurance companies of purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 per centum or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses;"
>
> (emphasis supplied)

Without laboring the point as to the right of a rural electric cooperative to be eligible for complete income tax exemption, under the Section quoted, as a "like organization", suffice it to say that an organization claiming tax exemption must sustain the burden of bringing itself strictly within the law granting such exemption. This rule is of universal application. (4) Furthermore, tax exemptions and the right to reduce taxable income liability, by deductions or exclusions from otherwise gross taxable income, are not matters of right, but matters of legislative grace; the right to be exempt or to reduce taxable income by exclusions or deductions being most strongly construed against the claimant to the right. (5)

The statutory exemption under discussion has been implemented by Treasury regulations, which indicate the administrative posistion as to the application of the statutory provisions. The following is quoted from applicable Treasury regulations; (6)

> "It is a prerequisite to exemption under Section 101(10) that at least 85 percent of the income of the organization

shall consist of amounts collected from members for the sole purpose of meeting losses and expenses. If an organization issues policies for stipulated cash premiums, or if it requires advance deposits to cover the cost of the insurance and maintains investments from which more than 15 percent of its income is derived, it is not entitled to exemption. On the other hand, an organization may be entitled to exemption, although it makes advance assessments for the sole purpose of meeting future losses and expenses, provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members." (emphasis supplied)

It is true that neither Section 101(10) nor the Treasury regulations specifically provide, in so many words, that the organizations entitled to exemption thereunder shall be nonprofit in character. In other words, the phrases "non-profit" or "not-for-profit" are not found in the statute. But, considering the language of the statute as a whole — and especially the provision that 85% of the income must be limited to collections made to provide for losses and expenses — a nonprofit, or very limited profit operation is indicated.

The regulations, unfortunately, only specifically implement the statute insofar as local mutual life insurance companies are concerned, but an analogy between the basic operations of such mutual insurance companies and rural electric cooperatives may easily be drawn, at least insofar as corporate income is concerned. If an insurance company collects an advance stipulated premium in cash, exemption is denied. The reason is readily apparent. The advance cash premium is based on a formula which not only includes anticipated losses and expenses, based upon experience tables, but, also, a so-called "loading charge", which comprehends acquisition costs, contingencies, profits, and other items. These characteristics of stipulated advance premiums are, and have been long recognized by the insurance industry.

The excess of income resulting from the difference between the sums collected as stipulated cash premiums, over payments of or provision for losses and expense, is carried to the surplus of the company. Generally, and almost in universal practice, at the sole discretion of the company, a part of the surplus may be returned to policyholders as participating dividends. But the company is under no binding obligation to pay such participating dividends, and the policyholders are not entitled to receive the same as a matter of right. The insurance company may, and often does, retain the entire surplus as corporate profits.

On the other hand, in companies operating on the assessment basis, the assessments, predicated on actual losses, plus expenses, are levied either after losses have been incurred, or in anticipation of more or less immediate losses. It is to be noted that excess income not required to pay actual losses and expenses, is refundable to the member policyholders from whom collected. This plan negatives the accumulation of any corporate surplus refundable, or

nonrefundable, at the discretion of the corporation. To state it another way, this plan clearly indicates an operation on a cost or nonprofit basis. Considering the grouping of the different organizations in Subsection 10 of Section 101, it would appear that the rule ejusdem generis would apply.

In many mutual or cooperative telephone companies, instead of having a fixed service charge, which is paid by subscribers regardless of costs and expenses of operations or losses, the companies assess against subscribers or members the actual cost of operation. In such an operation, no profit may inure to the cooperative corporation. It is conceivable that the same sort of situation may apply to rural electric cooperatives. Such a cooperative may have a fixed contract or published tariff rate, which yields a revenue in excess of costs, expenses and losses, in which event there is a possibility of the accrual of a corporate profit. On the other hand, the cooperative may predetermine the actual costs, expenses and losses, and assess the members for their proportionate share thereof, after the rendition of service.

In passing, brief mention may be made to the fact that the statute refers to collections from members. No reference is made to collections from nonmembers, unless it is implied in the 15% tolerance provided in the statute. Without further discussion of this phase of the matter, it is suggested that the provisions of Section 101(10) be compared with those of Section 101(12), granting exemption to agricultural marketing and purchasing cooperatives. In the latter section, specific reference is made to marketing of products of "members and other producers", and purchasing supplies for "members and others". It must be presumed that Congress made this distinction in the two subsections advisedly.

A True Cooperative Defined

Before addressing the discussion more specifically to the capital credits, the subject may be better comprehended if the true nature of a cooperative, as judicially defined, is considered. An unequivocal definition of a true cooperative was formulated by the Ninth Circuit Court of Appeals in a case decided in June, 1946. (7) This is of more than passing interest, because the Ninth Circuit Court has heard and decided more cases involving the taxation of cooperatives than any other Circuit Court in the Nation. The judicial definition is quoted:

> "In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of goods sold. Such an obligation may arise from the association's articles of incorporation, its by-laws, or some other contract." (emphasis supplied)

In a more recent case, decided by the same Court, it was held that a cooperative marketing association, organized under the cooperative laws of

California, was a trustee for the benefit of its members, and, as such, a fiduciary, was obligated to account to them for all excess of receipts over expenses. (8) This case was decided in 1947, and certiorari was denied by the Supreme Court on January 5, 1948.

THE CAPITAL CREDIT

The term "capital credit" appears to have had, at least so far, application only to rural electric cooperatives. The terminology is of no significance, however, since it is a blood relative of "patronage refunds", "patronage dividends", "Trade discounts", "capital retains", "patrons' equities", and many other rebate items designed to reflect the interest of members and patrons of cooperative in the capital of the cooperative corporation.

The rural electric cooperatives are of too recent origin to have received any extended judicial examination. However, the tax position of general farmer cooperatives has been the subject of extended judicial examination and review for over a quarter of a century. The pattern of the law applicable to the income tax position of such cooperatives may now be said to be fairly well fixed or established. The cooperative method of operation of corporations of this class is so similar and analogous to that of rural electric cooperatives that there is no reason to doubt that the law applicable to one class is not applicable to the other.

The underlying principle which distinguishes cooperative corporations from general corporations is that the cooperative, as a corporate entity, must operate on a cost or nonprofit basis, and not for any income of its own, as such corporate entity. There are some minor modifications to the broad general statement, but the minor exceptions serve to emphasize the rule, rather than to weaken it.

There are two basic ways in which a cooperative may operate on a nonprofit basis. The first is where the cooperative predetermines the actual cost of service and only charges such actual cost in the first instance. This method, while theoretically sound, is not practicable, because of the difficulty, if not sheer impossibility, of determining the exact cost in advance of or concurrent with the rendition of service.

The second, and the most generally accepted method followed by cooperatives is to add a margin of safety for unforseen contingencies to the estimated cost of the service, with the stipulation that at the close of the given fiscal period, when the actual cost of service has been determined by proper accounting procedures, the excess of the amount collected over actual cost will be refunded to the persons making such payments, in proportion to the amounts paid by them for the services which they have received. If the refund is paid in cash, the transaction is closed upon the making of the cash payment. If the refund is made by the issuance of redeemable corporate securities, as the equivalent of cash, the transaction may not be said to be completely closed until the securities are redeemed or retired. Pending the redemption or

retirement of such securities, the same represent capital advanced to or invested in the cooperative by the consumers, and is reflected in the capital liabilities of the cooperative.

In many cases, such capital advances to or investments in cooperatives by the patrons are evidenced by the issuance of shares of stock, certificates of indebtedness, debentures, or certificates of equity. The certificate of equity most closely resembles the capital credit certificate. Regardless of the form of the certificate, however, they all serve the same purpose, i.e., evidence of the interest of the patron in the capital of the cooperative. Very, very few of such instruments evidencing investment by patrons in the capital of the cooperative have fixed due dates. Also, the vast majority of such certificates are redeemable or retirable upon call by the governing board of the cooperative. The generally accepted practice in the redemption of capital certificates, is upon the revolving fund plan, which merely means that the certificates are redeemed in the order of the dates of issue, the oldest being redeemed prior to those of later issue.

Function of Capital Credits

In determining the nonprofit character of a cooperative, it is necessary to ascertain whether the cooperative, as a corporate entity, separate and apart from its members, can have, or does have income arising from its operations, which it can legally claim to be its own corporate property. Mere possession or receipt of money or property by a cooperative — or, for that matter, by any other corporation, firm, or person — is not controlling in the determination of corporation income. The real question is - Who is the lawful owner of the money or property in the physical possession of the cooperative?

In the absence of any specific provision to the contrary, it must be presumed that money coming into the hands of a cooperative is its corporate money or property. However, by virtue of lawful contracts, entered into prior to the receipt of money or property, the cooperative may obligate itself to return all, or a specified portion of receipts to others, in which event the receipts subject to refund or return to others, do not constitute a part of the corporate income, but become the income of the recipients thereof, to whom the cooperative is bound by such contractual obligation to refund or return the same.

If the cooperative is bound to return the excess of income or revenues, over expenses, to its customers, consumers, or patrons, in cash, there is no question on the part of the most bitter opponents of cooperatives, that such cash refunds are not corporate income. This view has received the sanction of the courts in many cases. The leading case so holding is one in which a number of insurance companies formed a corporation to print and produce for them uniform insurance policies. The printing cooperative charged its member insurance companies, at the time of the delivery of the policies, an amount conceded to be in excess of the cost of production. The printing cooperative was under legal contractual obligation to refund, annually, to its member patrons all excess of income over cost of production, in proportion to their

respective volume of business with the cooperative. The refunds or rebates were true cooperative patronage refunds, in every sense of the word. However, the court sanctioned the exclusion of such refunds from the corporate income on the ground that they constituted accumulated trade discounts. (9)

The controversy appears to arise when the cooperative, instead of paying the refund to the patrons in cash, retains the amount thereof for capital purposes; credits to each patron his proportionate share in such refunds; and issues to the patron some form of corporate security or certificate evidencing the patron's interest in such corporate capital acquired by the retention of refunds. However, it should be emphasized that the mere observance of such a practice, without more, even though acquiesced in by the patrons, is not sufficient, in and of itself, to convert the retentions from corporate income to corporate capital.

To convert what would otherwise be corporate income into corporate capital, there must be a legally binding obligation, created by contract between the cooperative and its patrons, authorizing this practice. Furthermore, the contract between the cooperative and its patrons must be executed and in effect before the receipt of the refundable revenue by the cooperative. (10) Otherwise, if the cooperative has within its unqualified discretion the right to refund or to retain excess revenues, the excess revenues have the character of corporate income, no different than surplus earnings of a corporation, out of which it may or may not declare dividends on capital stock.

The Contract Creating Capital Credits

Before discussing the aspects of the contract out of which capital credits or invested patronage refunds are created, it may be proper to again stress the fact that mere possession of money does not, in and of itself, create income to the person or corporation in possession. The following quotations from a comparatively recent decision of the Supreme Court of the United States are illuminative: (11)

> "The very essence of taxable income, as that concept is used in Section 22(a), is the accrual of some gain, profit or benefit to the taxpayer."
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> "Nor is mere dominion over money or property decisive in all cases."
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> * * * * * *
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> "For the present purposes, however, it is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain, and (2) the absence of a definite unconditional obligation to repay or return that which would otherwise constitute a gain."

* * * * * *

"Nor can taxable income accrue from mere receipt of money or property which one is obligated to return or repay to the rightful owner, as in the case of a loan or credit."

(emphasis supplied)

Now to the cooperative contract —

First, the contract should provide that all excess of receipts and revenues by the cooperative, over the expense of operations, shall be returned or returnable to the patrons out of whose patronage such excess receipts arose, in proportion to their patronage.

Second, the contract should provide that each patron is obligated to periodically invest all, or a part of the refund to which he is entitled, in the capital of the cooperative, no matter how this capital may be evidenced.

Third, the cooperative should issue to each patron whose refunds have been retained, in whole or in part, as capital, some certificate or evidence of the patron's interest in the capital of the cooperative. Such certificates can be for shares of stock, equity certificates, debentures, capital credit certificates, or certificates of a similar nature or character.

Fourth, the records of the cooperative should be so kept that the interest of each patron in the contributed or invested capital of the cooperative may be readily ascertained at all times.

Fifth, the contract should provide that the patron authorizes the cooperative to apply so much of the refunds due him to a capital obligation, without further action on the part of the patron.

Sixth, the capital contribution should be redeemable or retirable at the option of the cooperative, on a revolving fund plan of redemption, whenever the capital of the cooperative is adequate to permit such redemption without impairing its operations.

Such a contract may be created by separate written instruments, executed between the cooperative and its patrons, or may be included in the cooperative's articles of incorporation or by-laws, or both, which, as a matter of law, constitute a contract between the cooperative and its patrons.

It has been held that under such a contract, the net result is the same as though the cooperative had paid to its patron the refund in cash and, thereupon, the patron had immediately fulfilled his obligation by investing the cash in the capital of the cooperative. The case so holding has been followed on several occasions. (12)

Pickwick Electric Membership Case

Perhaps everyone is familiar with the Pickwick Electric Membership Corporation case, decided by the Sixth Circuit Court of Appeals. (13) Here, under the provisions of the corporate by-laws, the cooperative charged its member patrons for electricity consumed a rate which was divided into two parts. The first part was at the rate of 1¢ per KWH, and not to exceed $1.00 per month and this was to be credited to an amortization fund, and was to be segregated from all other funds in the possession of the cooperative. It was to be used exclusively for the payment of principal and interest on long-term debt incurred in acquiring the cooperative's electric system.

The second part of the rate was based upon the cost of current furnished, the by-laws providing that the excess revenues over expenses arising from this portion of the rate should be applied to patronage refunds, payable to the members or to general rate reductions.

The Court held that no part of the revenues were taxable to the cooperative as its corporate income, because: (1) the amortization fund consisted of capital contributions, as distinguished from income; and (2) the general revenues, in excess of expenses and losses, were the property of the members and not that of the corporation.

So far so good. Then, the Court spoiled an otherwise splendid decision by holding that the cooperative was entitled to complete tax exemption under Section 101(8), I.R.C. as an organization "operated exclusively for the promotion of social welfare".

Other infirmities in the decision render the case of doubtful value, such as discrimination between member and nonmember patrons, and the earning of profits for members out of nonmembers' patronage.

I view this case with mixed emotions, and suggest that, as in the case of penicillin, it be applied only in cases of extreme emergency, and then in very small doses.

RECOMMENDATION

If there be any constructive recommendation which I can make here, it is that which I have been constantly making to general farm cooperatives. All cooperatives serving in rural areas, whether presently entitled to complete and outright tax exemption or not, would do well to adopt the capital credits plan, or some similar plan of corporate financing. Tax exemption is often a mighty frail reed upon which to lean.

It should be kept in mind that tax exemption is a matter of legislative grace. It is also, to some extent, a matter of administrative grace in interpreting the application of the exemption statute. Legislative and administrative grace may be withdrawn just as readily as it was extended in the first instance.

Should tax exemption be denied or withdrawn, a cooperative which has legally and effectively adopted a capital credits plan may reduce its income tax liability to a minimum, approaching zero, in many instances. By adopting the capital credits plan, the cooperatives have nothing to lose and may have much to gain, even to the extent of the assurance of the continued existence of the cooperative.

Everyone knows that the National Tax Equality Association is the most bitter, most active, most ruthless, and most vocal opponent of agricultural cooperatives. To date, N.T.E.A. has centered its attack on general farmer cooperatives, skirting gingerly away from rural electric cooperatives. As you know, N.T.E.A. professes to be the instrument of salvation of small business men, sent from Heaven, to save small business from the rapacity of the ever expanding host of cooperatives.

Does the bypassing of electric cooperatives by N.T.E.A. at this time mean that such cooperatives have been tried and found not wanting, and therefore, escape attack? I wish I could be naive enough to believe this.

If you have not already done so, I suggest you examine the list of contributors to N.T.E.A., as disclosed recently at the hearings before the House Committee on Small Business. The largest contributors, both in dollars and effective members, are the public utilities companies. Are these contributions by public utilities to the $1,250,000.00 jackpot of N.T.E.A. charitable gifts, from which no return is expected? Or, are these contributions designed to enable N.T.E.A. to save the public utilities from rapine and extinction by the rural electric cooperative? Your guess is as good as mine!

However, it is my suggestion that now is the proper time to commence to forge the lock for the barn door.

(1) Read vs. Tidewater Coal Exchange, 13 Del. Ch. 195; 116 Atl. 898

(2) Title 7, Sec. 904, F.C.A. (Rural Electrification Act of 1936)

(3) Title 26, Sec. 101, F.C.A.

(4) Farmers Mutual Cooperative Creamery of Sioux Center, 33 B.T.A. 117

Fertile Cooperative Dairy Assn. vs. Huston, 119 Fed.(2d) 274

(5) Cooperative Oil Assn. vs. Commissioner, 115 Fed.(2d) 666

(6) Treasury Regulations 111, Sec. 29.101(10)-1

(7) American Shook Box Export Assn. vs. Commissioner, 156 Fed.(2d) 629

(8) California and Hawaiian Sugar Refining Corporation vs. Commissioner, 163 Fed.(2d) 531

(9) Uniform Printing and Supply Co. vs. Commissioner, 88 Fed.(2d) 75

(10) Juneau Dairies, Inc., 44 B.T.A. 759

Associated Grocers of Alabama vs. Wellingham, 77 Fed. Supp. 990

Peoples Gin Co. vs. Commissioner, 118 Fed.(2d) 72

American Shook Box Export Assn. vs. Commissioner, 156 Fed.(2d) 629

Fruit Growers Supply Co. vs. Commissioner, 56 Fed.(2d) 90

Fountain City Cooperative Creamery Assn. vs. Commissioner, 172 Fed.(2d) 666

Druggists Supply Corporation, 8 T.C. 1343

(11) Commissioner vs. Wilcox, 66 S.Ct. 546

(12) United Cooperatives, Inc., 4 T.C. 93

(13) United States of America vs. Pickwick Electric Membership Corporation, 158 Fed.(2d) 272

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